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TO AMEMBASSY PARIS IMMEDIATE

C O N F I D E N T I A L STATE 082951

PASS ASSISTANT SECRETARY ENDERS

FOL REPEAT OF ABU DHABI 762 TO SECSTATE INFO DOHA JIDDA KUWAIT
MANAMA TEHRAN APR 10

QTE:

C O N F I D E N T I A L ABU DHABI 0762

DEPARTMENT PASS TREASURY AND FEDERAL RESERVE

E.O. 11652: GDS

TAGS: EFIN, TC

SUBJ: UAE REVALUATION OF THE DIRHAM

REF: (A) ABU DHABI 587 (B) ABU DHABI 600

SUMMARY: DESPITE OFFICIAL ANNOUNCEMENT IN MARCH THAT DIRHAM
WOULD REMAIN PEGGED TO DOLLAR, LOCAL BANKERS BELIEVE SWITCH TO
SDR IS IN OFFING, REVALUING DIRHAM BY 2.3 PERCENT. BANKERS
BELIEVE EFFECTIVE REVALUATION WILL BE FIVE PERCENT INITIALLY. END
SUMMARY.

1. FIVE DAYS AFTER SAUDI SWITCH TO SDR, UAE CURRENCY BOARD
OFFICIALLY ANNOUNCED DECISION TO REMAIN PEGGED TO DOLLAR QUOTE
AT THE PRESENT TIME UNQUOTE. OFFICIALLY, REASONS FOR
THIS DECISION WERE TWO: (A) REVALUATION OF ONLY 2.3 PERCENT
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WOULD BE ABSORBED BY IMPORTING MERCHANTS AND NOT LOWER

DOMESTIC PRICES AND, (B) REVALUATION WOULD REDUCE GOVERNMENT DIRHAM REVENUE AT A TIME OF FINANCIAL CONSTRAINTS DUE DROP IN PRODUCTION RATES (ABU DHABI RECEIVES 60 PERCENT OF TAX PAYMENTS IN DOLLARS). UNOFFICIALLY, REASON IS THAT CURRENCY BOARD FEARS PROSPECT OF LOSING 900 MILLION DIRHAMS (ABOUT 225 MILLION DOLLARS).

2. RUMORS OF A DIRHAM REVALUATION HAD BEEN SURFACING SINCE JULY 1974. ACCORDING TO BANKING SOURCES, THERE WAS SOME MOVEMENT OUT OF DOLLARS INTO DIRHAMS AT THAT TIME, BUT WHETHER THE FLOWS WERE COMING FROM ABROAD OR LOCAL MERCHANTS WERE SIMPLY HEDGING, COULD NOT BE DETERMINED. MOVEMENT ACCELERATED IN NOVEMBER OF THIS YEAR WHEN, THROUGH CURRENCY BOARD REGULATIONS, INTEREST RATES ON LOCAL CURRENCY TIME DEPOSITS INCREASED. THIS MOVEMENT CREATED PROBLEMS OF EXCESS DIRHAM LIQUIDITY SINCE THERE IS NO FOREIGN DEMAND FOR DIRHAMS AND LOCAL LENDING OPPORTUNITIES QUITE LIMITED. AT SAME TIME BANKS WERE UNWILLING TO ASSUME EXCHANGE RISK BY HOLDING FOREIGN EXCHANGE. EXCESS DIRHAMS COULD HAVE BEEN RECONVERTED TO FOREIGN EXCHANGE FOR LENDING ABROAD, BUT CURRENCY BOARD DISCOURAGED SUCH OPERATION BY REFUSAL TO GIVE FORWARD COVER. THUS BANKS CONTINUED CREATE DIRHAM LIABILITIES AND SOLD FOREIGN EXCHANGE TO CURRENCY BOARD WHICH WAS BUYER OF LAST RESORT. SAUDI ANNOUNCEMENT ONLY AGGRAVATED THIS SITUATION AND CURRENCY BOARD REACTED INDECISIVELY. THE BOARD'S INITIAL GUIDANCE TO BANKS WAS VAGUE AND LEFT ROOM FOR INTERPRETATION. AS BOARD DELAYED FIVE DAYS BEFORE COMING OUT WITH DEFINITIVE STATEMENT, PUBLIC AND BANKS HURRIEDLY TOOK DIRHAM POSITIONS.

3. ATTEMPTED STRATEGY OF WAITING OUT THE SPECULATORS WAS BLOWN BY ABU DHABI FINANCE MINISTER HABROUSH IN NEWSPAPER INTERVIEW ON APRIL 7 WHEN HE ADMITTED THAT CURRENCY BOARD WOULD HAVE TAKEN LOSS WITH REVALUATION. HE WENT ON TO SAY THAT DIRHAM WOULD BE UNPEGGED AT SOME FUTURE DATE. HIS PUBLIC STATEMENT REINFORCED BANKERS' SUSPICIONS THAT DECISION WAS MADE TO PEG DIRHAM TO BASKET OF CURRENCIES AT TIME OF SAUDI ACTION IN MARCH, WITH IMPLEMENTATION DELAYED IN THE HOPE THAT SPECULATORS WOULD LIQUIDATE DIRHAM DEPOSITS. THERE WAS HOWEVER NO SIGN EVEN PRIOR TO HABROUSH'S PUBLIC

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GAFFE, THAT THE STRATEGY WOULD WORK. BANKS HAD BEGUN TO NOTE INCREASING BORROWINGS OF DOLLARS AND CONVERSION OF DIRHAM THREE-MONTH TIME DEPOSITS. IN LESS THAN ONE MONTH, RATES ON INTERBANK DIRHAM LOANS HAVE FALLEN FROM 4 1/2 TO 3 1/2 PERCENT.

4. IT WOULD THUS APPEAR THAT REVALUATION IS JUST A MATTER OF TIMING. BUT REVALUATION PRESSURE HAS TO BE WEIGHED CAREFULLY

AGAINST DOMESTIC CONSEQUENCES OF SUCH A DECISION. IF
HABROUSH'S ESTIMATE OF BOARD'S POTENTIAL LOSS IS ACCURATE,
THEN DOMESTIC LIQUIDITY WOULD BE SERIOUSLY AFFECTED SINCE
UAE OFFICIAL TOTAL FOREIGN EXCHANGE HOLDINGS AMOUNT TO
LITTLE MORE THAN 2 BILLION DIRHAMS (ABOUT DOLLARS 500 MILLION).
IN ORDER TO MAINTAIN DESIRED LEVEL OF DOMESTIC LIQUIDITY,
CURRENCY BOARD WOULD HAVE TO BORROW FROM ABU DHABI FINANCE
MINISTRY, ONLY ADDING TO ANOTHER STRAIN ON ABU DHABI'S LIMITED
REVENUE. THUS, WHILE IT CLEAR THAT UAE MAY WANT TO PEG
DIRHAM TO SDR OR ANY OTHER CURRENCY BASKET, DOMESTIC CON-
STRAINTS LIMITED FREEDOM OF ACTION. CURRENCY BOARD AND
SPECULATORS ARE NOW DEFINITELY TRYING TO OUT WAIT ONE ANOTHER,
AND IT DIFFICULT TO PREDICT WHO WILL WIN.
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